No. 12,080

IN THE

United States Court of Appeals

For the Ninth Circuit

BASALT ROCK CO., INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONER'S REPLY BRIEF.

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PETITIONER'S REPLY BRIEF.

The Government's brief simply restates the position of the majority of the Tax Court. Aside from an argument based upon a misinterpretation of the word "distorted," as used in the Senate Committee report, and certain unsupported assertions with respect to alleged discriminatory tax advantages, it is fully answered in our opening brief. We confine this reply, therefore, to a statement of the inaccuracies in the Government's argument.

THE GOVERNMENT'S CONTENTION THAT IT RELIES UPON THE "LITERAL LANGUAGE OF THE STATUTES."[1]

Petitioner throughout has relied upon the plain words of the statute. Now the Government says that it, also,

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[1]Government's brief, p. 13.

relies upon the "literal language" of the statute;[2] that "the statute, on its face, requires the meaning contended for by the Commissioner";[3] and that it is the taxpayer who urges a "strained construction"[4] and a "judicial rewriting of the terms actually used by the legislature."[5]

We submit that if the Government's brief and the majority opinion of the Tax Court do make one thing plain, it is that, of the parties, it is the Government who resorts to construction, and that the only question here is whether the plain language of the statute must yield to that construction.

In so many words section 710(a)(1)(B) provides that the alternative tax shall be in

> "(B) an amount which when added to the tax imposed for the taxable year under Chapter 1 * * * equals 80 per centum of the corporation surtax net income, computed under section 15 * * *."

Section 15 provides that "the term 'corporation surtax net income' means the *net income* [minus certain credits]."

And section 41 specifically provides:

> "The *net income* SHALL BE COMPUTED upon the basis of the taxpayer's annual accounting period * * * *in accordance with the method of accounting regularly employed in keeping the books of such taxpayer;* * * *."[6]

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[2]Government's brief, p. 13.
[3]Government's brief, p. 29.
[4]Government's brief, p. 24.
[5]Government's brief, p. 25.
[6]Emphasis throughout the brief is added.

The Government's argument is that these words do not mean what they say; that section 736(b), read with section 711(a), necessarily provides for two normal tax net incomes; that since there be two such incomes there must also be two corporation surtax net incomes; and that of these two the one referred to in section 710(a)(1)(B) is a corporation surtax net income computed in part under section 15 and in part under section 736(b). Its argument runs that if the election provided by section 736(b) is to be reflected in the tax imposed by section 710(a)(1)(A), the phrase "to compute * * * income" in section 736(b) carries the elected method, because of the provisions of section 711(a), back through the provisions of section 13(a)(2) into the computation of net income under section 21 and thence (retracing the steps) into the computation of the corporation surtax net income under section 15 and thence into section 710(a)(1)(B).

The sum of the argument is:[7]

> "Accordingly, since percentage of completion is the proper accounting method employed (once the election is made under Section 736(b)) in computing the 'net income' from which is derived the 'normal tax net income, as defined in section 13(a)(2), for such year,' from which is derived the 'adjusted excess profits net income' for the tax under Section 710(a)(1)(A), the same method of accounting is equally required in computing the same 'net income,' from which is derived the 'corporation surtax net income, computed under section 15,' and which de-

[7]Government's brief, p. 21.

termines the tax or the limitation on the tax under Section 710(a)(1)(B)."

This whole argument, we submit, is artificial and erroneous. It rests solely upon a series of unsupported and fallacious assumptions.

First, the Government assumes that if section 736(b) is to be given any effect the taxpayer who makes an election under section 736(b) has one "normal-tax net income, as defined in section 13(a)(2)," computed by the accounting method required by section 41 (upon which its normal tax is based), and a second and different "normal-tax net income, as defined in section 13(a)(2)" computed by the accounting method under section 736(b) (which is the normal-tax net income referred to in section 711(a)). Assuming this, the Government next assumes that such a taxpayer must have one "corporation surtax net income, computed under section 15," computed by the accounting method prescribed by section 41 (upon which its surtax is based), and a second and different "corporation surtax net income, computed under section 15," computed by the elected method (or, we must presume, by both this method and that provided in section 41 if the taxpayer has income other than long-term contract income). And, finally, assuming this, it assumes that the second surtax net income is the one referred to in section 710(a)(1)(B) as the measure of the 80 per cent limitation.

These assumptions are without warrant. Of course, a taxpayer has only one "normal-tax net income, as defined in section 13(a)(2)," just as it has only one "surtax net income, computed under section 15." Each of these sec-

tions permits the use of one method of accounting and no other—that prescribed in section 41. The reference in section 711(a) can only be to the actual "normal-tax net income, as defined in section 13(a)(2)." If doubt existed it would be dispelled by section 728 of the Excess Profits Tax Act, which provides:

> "The terms used in this subchapter shall have the same meaning as when used in Chapter 1."

Nowhere in the Excess Profits Tax Act is it provided that the "normal-tax net income, as defined in section 13(a)(2)" is changed into a different "normal-tax net income, as defined in section 13(a)(2)" for the purposes of that act. Nowhere is it provided that the steps involved in the computation of normal tax net income under section 13 need be retraced. The relationship between Chapter 1 and the Excess Profits Tax Act is manifest. The basic concepts of net income are established in Chapter 1 and those concepts are utilized in Subchapter 2E in arriving at the excess profits tax. They are utilized by bringing into Subchapter 2E the income computed under the familiar concepts of Chapter 1 which reflect the ordinary income—the ordinary profits—of the taxpayer and subjecting this income to the adjustments provided in Subchapter 2E. These adjustments result in the "adjusted excess profits net income" which is subjected to the excess profits tax. Certain of these adjustments are prescribed in section 711(a). Another is the adjustment provided by section 736(b) by which *that part* of the taxpayer's net income derived from long-term contracts is recomputed under the elected method. Section 736(b) itself so characterizes its effect. Immediately succeeding

the sentence providing for the election to compute income, the section further provides[8] that the "net income" of the taxpayer for prior years (as well as the year for which the election is made) shall be "*adjusted* for the purposes of this subchapter," and express reference is made to the "*adjustment* required by this subsection."

The Government's whole argument—that Subchapter 2E requires a retracing in some physical sense of all the steps in the computation of income under Chapter 1 so that there is thereby produced in Chapter 1 two normal tax net incomes and two corporation surtax net incomes —simply substitutes casuistry for substance. As stated by the court in *Allen v. Morsman* (8 Cir. 1931) 46 F. 2d 891, 893:

> "Where a series of statutes have been enacted, as they have with relation to the difficult and intricate question of income taxes, an argument for almost any theory of construction can be built up under them, and courts can of course construe words and phrases therein to cover matters which Congress perhaps never had contemplated, but it is the duty of courts to construe the statutes so as to arrive at the intention of Congress, as gathered from the statutes themselves, and not to indulge in speculation as to what different phrases in a statute might possibly be held to mean."

The only authority cited by the Government is language from the opinion of the Tax Court in *West End Furniture Co.*, 6 T. C. 557—a case in which the point actually decided is no precedent on the question here involved. As we

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[8]In the next to the last sentence. Appendix, Petitioner's Opening Brief, p. vi.

have pointed out,[9] the Tax Court in that very case went on to determine the exact question here in issue in accord with petitioner's contention and the judge who wrote the opinion is one of the judges who dissented here (R. 176).

As a matter of fact the *West End Furniture* case demonstrates the absurdity of the Government's contention. In that case the taxpayer, when it recomputed its corporation surtax net income in accordance with the Regulations and with the Government's contention and computed 80 per cent of that figure, *arrived at an amount less than the amount of its normal tax and surtax under Chapter 1.* As a result the 80 per cent limitation was *less* than its Chapter 1 taxes—a result which the court held to be clearly erroneous (R. 118), and which Congress never could have contemplated, since section 710(a)(1)(B) provides that the alternative tax shall be in an amount which when *"added"* to the Chapter 1 taxes equals 80 per cent of the corporation surtax net income.

Further, if it were true—as we submit it clearly is not—that a taxpayer electing under section 736(b) has more than one "normal-tax net income, as defined in section 13(a)(2)," this still would not warrant the assumption that the taxpayer also has more than one "corporation surtax net income, computed under section 15," and that the recomputed surtax net income is the one referred to in section 710(a)(1)(B). If it be assumed with the Government—contrary to reason and to the statute—that the elected method can be given effect in arriving at the adjusted excess profits net income subject to tax under sec-

[9]Petitioner's Opening Brief, pp. 38-40, 58-59.

tion 710(a)(1)(A) *only* by creating a second normal tax net income, then at least it could be said that that was one way of effecting the Congressional purpose in enacting section 736(b). But no such purpose would be effected by a similar artificial creation of a second "corporation surtax net income, computed under section 15." Nowhere in the Regulations, the opinion below, or in the Government's brief is it pointed out what Congressional purpose is achieved by such a construction. The Government's brief nowhere states just how the substitution for the taxpayer's ordinary corporate income of a specially constructed "income" nearly three times greater than its ordinary income, as the measure of the 80 per cent limitation, would achieve the Congressional intent to prevent a case in which the "combined effective rate of the normal tax, surtax, and excess-profits tax would approach 90 per cent" of such income, and insure "that *in no case* should more than 80 per cent of corporate profits be taken in normal tax, surtax and excess-profits tax"—all as so clearly set forth in the Senate Committee Report.[10]

The Government overlooks the fact that the intent of section 710(a)(1)(B) is to place a limitation upon the "combined effective rate of the normal tax, surtax and excess-profits tax."[11] It was natural that Congress should, as it did, select for this over-all limitation a percentage of the taxpayer's ordinary income. No argument, however adroit, can negative this simple fact or establish that the Congressional intent is not wholly defeated by the result for which the Government contends.

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[10]Petitioner's Opening Brief, pp. 43-44.
[11]Senate Report, Petitioner's Opening Brief, p. 43.

THE GOVERNMENT'S "CONSISTENCY" ARGUMENT.

The Government makes no answer to the discussion in our opening brief (pp. 32-41) showing that the doctrine of "consistency" has no application to the problem here presented. However, it continues to assert[12] that petitioner seeks to use two different accounting methods for excess profits tax purposes, and at least suggests (by the quotation from the admittedly inapplicable *South Texas Co.* case (p. 29)) that this offends the doctrine of consistency.

There is no inconsistency in the use of different accounting methods to arrive at two entirely different measures of a tax.[13] The very structure of the Excess Profits Tax Act indicates that Congress intended that in particular situations one method of arriving at the income to be taxed is to be preferred over another method. Throughout the Act the taxpayer is given choices as to which method it prefers to use, with the general object, of course, of imposing the lowest tax upon the taxpayer. Thus the taxpayer is given the choice of two different computations in arriving at its adjusted excess profits net income (sections 711(a)(1) and 711(a)(2)), and a choice of two entirely different methods of computing its excess profits credit—the base period earnings method (sections 711(b) to 713(g)) and the invested capital method (sections 714 to 720). Certain taxpayers under section 736(a) are permitted to use the accrual method of accounting rather than the installment method, and section 736(b) provides a similar election. Throughout these calculations

[12]Government's brief, pp. 5, 7, 16 (footnote), 27, 29.
[13]See Petitioner's Opening Brief, pp. 36, 40.

consistent accounting methods must, of course, be used in arriving at particular income subject to tax, and no contention is or could be made that petitioner has in any way offended this rule.[14]

THE GOVERNMENT'S "DISTORTED INCOME" ARGUMENT.

At the outset of its argument (pp. 13-14), and elsewhere throughout its brief, the Government criticizes petitioner for insisting upon the right to employ a "distorted picture" of its earnings as a measure of its excess profits tax liability under section 710(a)(1)(B). This argument is built up from language in the Senate Committee Report[15] which in no way supports the Government's contention, but on the contrary directly confirms that of petitioner.[16] Before discussing this report, however, we point out the basic fallacy in the Government's reasoning —a fallacy brought out by the Government itself. In its brief (pp. 26-27) the Government recognizes that the method of accounting consistently used from year to year is the only one that accurately reflects a taxpayer's true income. Indisputably, in this case that method is the completed contract method. Upon its income so computed

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[14]See Petitioner's Opening Brief, pp. 32-41.
The type of consistency the Government demands obviously places it in an illogical position, for it insists the taxpayer must use its regular methods of accounting in arriving at its normal tax and surtax, both of which enter into the computation of the tax under section 710(a)(1)(B), but at the same time must use a different method of accounting in arriving at the other factor in the measure of that tax, "the corporation surtax net income."

[15]Petitioner's Opening Brief, p. 52; Government's brief, p. 10.

[16]See Petitioner's Opening Brief, p. 52.

petitioner paid its normal tax and surtax. Its income so computed was its income for all general corporate purposes. The Government also recognizes (p. 26) that if in any single year a different method of accounting is used it will *not* give an accurate picture of true corporate profits. Again, indisputably, in this case the elected method was the one adopted (as the statute permitted) for a special and temporary use. It is apparent, therefore, that if there be a distorted income in any true sense, it is the income computed by the elected method and not by the taxpayer's consistent accounting methods.

Turning to the Committee Report[17] it becomes clear that the Government's argument fails for a further reason. True, the report states that under the completed contract method income is "bunched" in the year of completion and presents a "distorted picture" of earnings unless the income is spread over the period of performance (a statement true in certain situations, but which overlooks the leveling effect of the termination, year by year, of a succession of long-term contracts), but the next sentence—*stating the purpose of the amendment*—shows that the concern of the Committee was to make certain that an excess profits credit during each year of performance could be utilized by the taxpayer in computing its adjusted excess profits net income. The other purpose of the amendment—and the only other purpose—is stated in that section of the report not quoted by the Government,[18] namely, to permit the adjustment of base period earnings for the purpose of increasing the excess profits

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[17]Petitioner's Opening Brief, p. 52; Government's brief, p. 10.
[18]Quoted in Petitioner's Opening Brief, p. 52.

credit based on income. In other words, the report demonstrates, as we pointed out in our opening brief (pp. 52-53), that section 736(b) was intended to affect the computation of the adjusted excess profits net income and *not* the computation of the corporation surtax net income which measures the over-all limitation of section 710(a)(1)(B).[19]

It must also be remembered that the Excess Profits Tax Act was a war measure, intended to be temporary and not expected to last for the period of time necessary to permit inaccuracies in income to be ironed out by the consistent use of a particular method of accounting over a number of years. In these circumstances it is quite obvious why Congress chose as the measure of the 80 per cent limitation the income reflected by the taxpayer's regular method of accounting. And it is equally obvious why Congress did not select as the measure of that limitation (although it permitted its use as a special relief measure in computing the income subject to the severe excess profits rates) a figure that reflected a distorted picture of the taxpayer's income, i.e., a figure arrived at by the temporary use of a different accounting method.

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[19]A further significant aspect of the legislative history which compels this conclusion is set forth in our opening brief at pp. 52-53. The Government's attempted reply is wholly unconvincing (brief, pp. 24-25).

THE GOVERNMENT'S "TAX ADVANTAGE" AND "DISCRIMINATION" ARGUMENT.

The Government further argues[20] that if the taxpayer is permitted to use its regular method of accounting, the completed contract method, in computing its surtax net income which is the measure of the tax under section 710(a)(1)(B), the taxpayer by manipulation may escape excess profits tax on a portion of its income.[21] This argument is one that properly might be addressed to a legislature but hardly to a court. In any event, the contention is based upon the erroneous assumption that a taxpayer on the completed contract method of accounting will have a number of years in which no income will be earned or reported and will then have a large amount of income to report in the year of completion.[22]

A more simplified and consequently more inaccurate picture of the actual operation of the income and excess profits taxes under actual business conditions could hardly be presented. Long-term contractors do not uniformly make predictable and consistent profits on the contracts they undertake.[23] A contract which in its early stages may give every indication of yielding a profit on completion may actually result in a large loss. The Government itself recognizes that the percentage of completion method of accounting, as well as the completed contract method, will not in any one year accurately reflect the

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[20]Government's brief, pp. 5, 14-15, 26-29.

[21]This argument, now urged only incidentally, occupied a large portion of the briefs filed by the Government in the Tax Court. It went unnoticed by that court.

[22]Government's brief, pp. 27-28.

[23]In this case the taxpayer suffered substantial losses (R. 60).

income which a taxpayer receives. On page 26 of its brief the Government says:

> "It is also fairly evident that, if only one year during the life of a long term contract is isolated, neither method of accounting gives an accurate picture of the true corporate profits for neither method bears any necessary relation to the money actually received during the year under the contract or to the costs incurred."

Further, a taxpayer engaged in a business involving the performance of long-term contracts obviously will ordinarily have more than one such contract. Different contracts will start at different times and be completed in different years. In fact, in this case the taxpayer during the tax year in question had in progress six different contracts (R. 55, 56). Under these circumstances it is clear that, far from having a series of years in which a taxpayer under the completed contract method will have no reportable income it will under ordinary business conditions have income to report in each year because of the completion of successive contracts. Furthermore, the Government overlooks the obvious fact that in the case where a contract ultimately is completed without profit or at a loss, the taxpayer may, under the percentage of completion method, have paid substantial amounts of taxes during years of performance although it ultimately suffers a loss under the contract.[24] Finally, the incidence

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[24]The Government's brief (p. 27) erroneously states that "* * * the percentage of completion method will always show more income than the completed contract method." This implies that the percentage of completion method will result in income ratably over the period of performance of the contract whereas the com-

of the excess profits tax upon long-term contract income may be affected by the amount of the taxpayer's other income. The sum of the whole matter is that under ordinary business conditions fluctuations of income of course will occur, regardless of what method of accounting is used, and that true income will be reflected from year to year only under the methods of accounting regularly employed.

Carrying its simplification to further lengths, the Government on page 14 of its brief states that

> "* * * the taxpayer is seeking an interpretation of the statute which, generally, would put taxpayers who regularly report their income on the completed contract basis in a more favorable position because they elect to use the percentage of completion method for excess profits tax purposes than could be enjoyed by taxpayers who regularly use the percentage of completion method."

But the Government then goes on to say that (pp. 14-15)

> "* * * it is also true that such a method of accounting [the completed contract method], if required of other taxpayers who have elected to report income from long term contracts on the percentage of completion method, would result in a decided tax disadvantage to them in particular tax years. Conse-

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pleted contract method will result in income only upon completion of the contract. Under the percentage of completion method the gross income from long-term contracts is reported upon the basis of the percentage of the contract work performed during the year and all costs incurred in such performance are deductible in such year. The performance during a particular year may result in costs which exceed the income attributable to such performance and under the percentage of completion method this would result in a loss in such year.

quently, while Section 736(b) was intended as a relief provision, it must be remembered that the construction contended for by the taxpayer will not be liberal to all taxpayers."

It is impossible to follow the Government in this argument. By its own statement taxpayers who regularly report their income on the completed contract method and exercise the election under section 736(b) would generally derive advantage from such election. But then it says that in particular tax years disadvantage might result to taxpayers who exercise the election. It appears to be the Government's contention that generally a taxpayer so electing would derive advantage under the petitioner's construction of the law. The fact that in a particular tax year a disadvantage may result certainly has no bearing on the over-all effect of the election.

The Government's inconsistency in this particular argument, however, is but small criticism. More fundamentally it is no argument at all, it is simply a statement unsupported by any evidence in the record or factual showing of any kind. In its opening statement before the Tax Court the Government took an exactly opposite position (R. 91-92):

"Along this line, I should like at this point, however, to point out to the Court that both Petitioner's position and Respondent's position cut both ways. That is, both positions can in some cases benefit the taxpayer and in other cases benefit the government. In this particular case Respondent's position benefits the government; I say 'benefit', I mean so far as deficiency and revenue is concerned, and is not

of benefit to the taxpayer, the petitioner here. In other cases, Petitioner's position here would be detrimental to the government's case, and the government's position would be beneficial to the taxpayer.

I believe it important to emphasize, if your Honor please, that both of these rules here, both of these positions, can work out in favor of the government or in favor of the taxpayer. It is almost fortuitous as to one case or another whether it will result in a deficiency or a refund."

The truth of the matter is that any particular provision of the excess profits tax may pinch in some situations and comfort in others, just as all the tax laws do. Whether a taxpayer would be in a better or worse position in measuring its tax under the 80 per cent limitation under the Government's attempted construction would, as we have seen, be entirely fortuitous. The results of an election under the Government's theory are wholly unpredictable, as the Government freely admits, not only as to particular taxpayers, but as to particular years. There is nothing in the Committee Reports dealing with the 80 per cent limitation that discloses any intention on the part of Congress that the limitation would not apply otherwise than to all taxpayers alike. The very purpose of section 710(a)(1)(B) was to place an over-all limitation on the income and excess profits taxes of all taxpayers, whether a taxpayer used the invested capital method or the income method, whether it was entitled to relief under section 722, or whether any of the other manifold provisions of Subchapter 2E applied to one taxpayer and did not apply to another.

The Committee report categorically states:[25]

> "* * * *in no case* should more than 80 per cent of corporate profits be taken in normal tax, surtax, and excess-profits tax."

Congress conceived section 710(a)(1)(B) as a simple alternative measure of the tax, cutting across all classes of taxpayers and affecting all alike. Only if the measure of the tax under section 710(a)(1)(B) is governed by the regular accounting methods of the taxpayer is the 80 per cent limitation applied uniformly, as Congress intended, to all taxpayers alike. The petitioner's contention neither betters nor worsens the application of the 80 per cent limitation, for the 80 per cent limitation is left unaffected by the election under section 736(b). Whether a taxpayer is eligible but does not exercise the election under section 736(b), or whether the taxpayer is not eligible to make the election because it uses the percentage of completion method as its regular accounting method, the result is the same—the regular method of accounting controls the 80 per cent limitation.

THE GOVERNMENT'S ARGUMENT AS TO THE EFFECT OF THE COMMISSIONER'S REGULATIONS AND AS TO THE CONTEMPORANEOUS CONSTRUCTION OF SECTION 710(a)(1)(B).

The Government concedes that the Commissioner's regulations upon which it relies in this case are merely interpretive (Brief, pp. 5, 8, 29, 31), but nevertheless argues that even if they embody only a "reasonable" or

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[25]Senate Report No. 1631, C.B. 1942-2, 504, 530; Petitioner's Opening Brief, p. 43.

"permissive interpretation of the statute" they must be upheld. The Government asserts:[26]

> "All the matters previously discussed in this brief, accordingly, require the conclusion that the provisions of the Regulations in question embody a reasonable and permissive interpretation of the statute, if they do not, indeed, represent the only correct interpretation."

The only "permissive" interpretation is the correct interpretation. It is crystal clear that the theories of petitioner and of the Government are diametrically opposed. One or the other represents the correct meaning of the statute, and that is the only meaning that may be applied here. Interpretive regulations are not given persuasive force but must stand or fall upon an independent construction by the court of the statute upon which they are based.[27]

The Government quotes a letter written in 1948 by the Chief of Staff of the Joint Committee of Congress on Internal Revenue Taxation stating that the Committee found "no basis for unfavorable criticism of * * * overassessments" or refunds based thereon resulting from an application of the Commissioner's regulations. From this the Government concludes that our "attempt to establish that the Joint Committee on Internal Revenue Taxation had taken a different view of the statute than that of the Commissioner is without any foundation."[28]

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[26]Government's brief, p. 31.
[27]Petitioner's Opening Brief, p. 54.
[28]Government's brief, p. 32.

It must be manifest that the final abandonment by the Staff of its objections to the refunds in no way affects the force of petitioner's showing that for years after the enactment of this statute the administrative construction expressed by the Commissioner's regulation was consistently challenged by the Staff.[29]

CONCLUSION.

We respectfully submit the decision of the Tax Court is erroneous and should be reversed.

Dated, San Francisco, California,
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[29]Petitioner's Opening Brief, pp. 56-60.